Superannuation Competitiveness and Efficiency

Individual Submission to Australian Government Productivity Commission

I note the Terms of Reference and congratulate the Productivity Commission on the Issues Paper.

The Treasurer identified two areas of central importance for superannuation: funding the economy and delivering retirement outcomes. There are several ways in which the current system for superannuation does not, and is not likely to, result in optimal results in either of these areas. The following steps should improve the ability of the superannuation system to fund the economy and deliver retirement outcomes:

1. Require RSEs to disclose fees at three different levels: fees that the RSE charges to act as a fiduciary agent, fees that are paid to related third parties and fees that are paid to unrelated third parties. Such fees should be readily identifiable as part of the preparation of Business Activity Statements for GST calculations.

2. Commission APRA to survey fees paid by RSEs to external parties for material functions and to provide the aggregated survey information to RSEs so that they can judge their own effectiveness and obtain a benchmark for fees paid to related parties.

3. Require RSEs to outsource material functions to external entities. These external entities may be related or unrelated to the RSE.

4. Encourage the development of distinctive products and approaches to meet the three distinct purposes of accumulation, transition and decumulation.

5. Discourage the use of risk profiling as a primary tool for providing financial advice to members.

6. Require RSEs to provide income projections as part of reporting to members.

7. Encourage those who provide surveys of fund returns to develop surveys that focus on money-weighted returns and income in retirement.

8. Acknowledge that lack of engagement is not necessarily bad for superannuation members providing that the RSE has the right motivation.

9. Consider the extent to which the economy can benefit from the closure of the CGT leakage at the point a superannuation account transfers from accumulation to decumulation.

Further explanation of these suggestions follows.

1. Fee Disclosure

Current fee disclosure in the Australian superannuation industry is not transparent. It is also encouraging investment strategies that will become increasingly concentrated in a narrow range of strategies, such as passive investment in a narrow range of publicly traded securities. The concentration of strategies introduces systemic risks to the economy. At the same time, other investment opportunities that could enhance the broader economy will remain starved of capital

As part of its fiduciary role, an RSE is responsible for a number of tasks. In return for taking on this fiduciary role, the RSE is entitled to extract payment for its services. However, the current fee disclosure rules mean that clients are not told the fee that is being extracted by the RSE to act in this fiduciary capacity. As a result, there is a lack of transparency at this fundamental fiduciary level and no clear pressure for RSEs to become more efficient.

Furthermore, current fee disclosure means that RSEs face a number of potential issues that can compromise their ability to act in the best interest of their clients.

As an example, an important role of an RSE is to identify and exploit investment opportunities. An RSE may take a view that there is an opportunity to extract returns by lending money to households or businesses. This could be implemented in a number of ways, some of which may include investment management costs and some others that may involve a third party guarantee by a bank or other highly rated organisation.

As another alternative, the RSE might simply lend money to the bank. It would then receive an interest rate after the bank on-lends the money and extracts an interest margin.

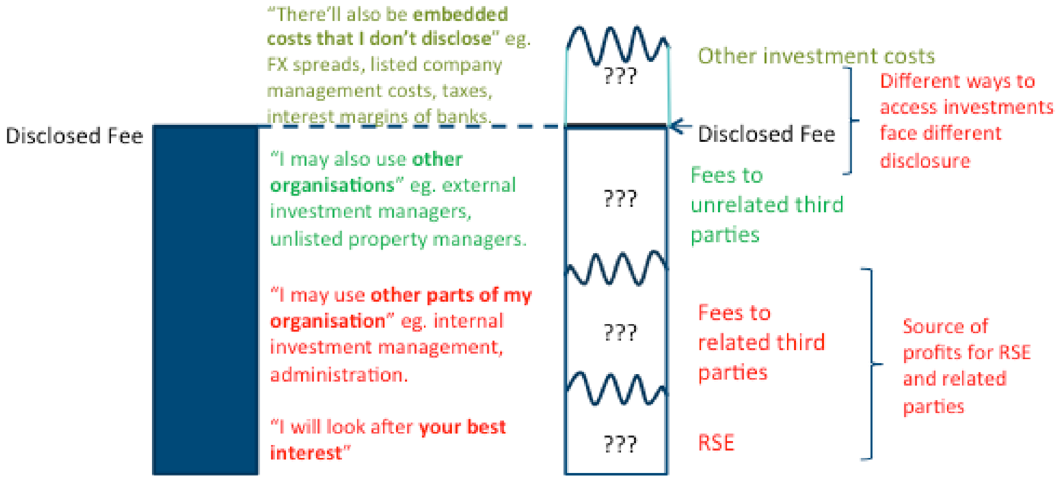
Now suppose that the RSE determines that the direct lending program can be implemented, with appropriate guarantees, at an average interest rate of 6% pa before costs and 5% pa after deducting costs. At the same time, the RSE sees that the interest rate being offered by a bank is 3% pa; with the "fee" that is represented by the bank's interest rate margin being unknown.

The direct lending program has an expected net return of 5% pa; the lending to the bank has an expected net return of 3% pa. However by pursuing the higher net return, the RSE risks being seen as uncompetitive in terms of fees even though the RSE itself may not be receiving any additional fee for its own account. The RSE is discouraged from even considering such disintermediation.

There are many more examples in which fee disclosure can discourage activity that would both improve retirement outcomes and make the economy more efficient.

The following diagram illustrates the sources of the compromised fiduciary duty.

Figure 1: Compromised Fiduciary Duty



Specifically:

- Vertical integration may bring undue pressure to use related party service providers.
- Choice of investment implementation can be compromised by different disclosure treatments of costs.
- Superannuation fund members have fiduciary agents but are not informed of what their agents are charging to provide the fiduciary services.

One potential response to this is to "look through all costs".

However, whenever money flows in the economy there is a potential for a proportion of that flow to be extracted as a payment. Such payments can take a variety of names including profit share, margin, brokerage, surcharge, bonus, wage, salary, tax, commission, rent, interest, carry, rebate, loading, disbursement, duty, royalty, rates and probably many more. They all are effectively some type of fee but trying to identify every single one is impossible. With apologies to Augustus de Morgan, *"Investment flows have little fees upon their backs to bite 'em. And little fees have lesser fees and so ad infinitum".*

Fortunately, such an extreme approach is also irrelevant if fee disclosure is modified in a way so that it emphasises the fiduciary relationship that the RSE has with its clients.

In order to make the industry more competitive and to allow RSEs to concentrate on net returns, fee disclosure should take the following form. These costs should be readily identifiable as part of the preparation of Business Activity Statements for GST calculations:

- Identify the costs being added and charged by the RSE to undertake its role as a fiduciary agent
- Identify fees and other payments from the RSE to related third parties and require the RSE to ensure that these are fair and reasonable, with assistance of the survey to which reference is made in the following Point 2.
- Payments to unrelated third parties should be competitive but should NOT be the focus for fee disclosure, as the only reason for an RSE to employ such third parties should be to pursue higher net returns for

clients. Such "fees" may represent the replacement of an implicit fee with a lower explicit fee and, in the interests of efficiency, RSEs should be encouraged to seek such opportunities.

Under this approach, RSEs will be encouraged to identify a greater range of potential investment opportunities and will be free to pursue the most efficient method of exploiting each of those opportunities. This will both improve retirement outcomes and make the economy more efficient.

At the same time, clients will be able to see exactly what they are being charged by their fiduciary agent and this will allow competition to be more effective at this level

If this approach is not implemented then the most likely outcome is that investment programs will increasingly become more and more concentrated in a narrow range of strategies, such as passive investment in a narrow range of listed shares and loans. Other investment opportunities that could enhance the broader economy will remain starved of capital.

2. Survey of Fees Paid

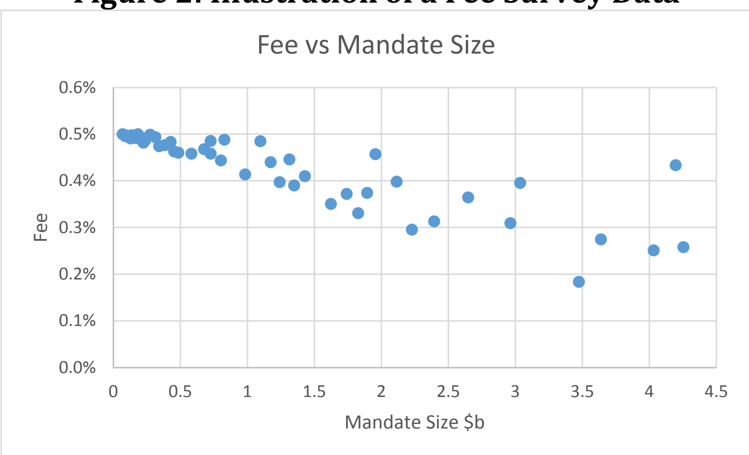
A potential problem with the fee disclosure approach described in Point 1 is that RSEs may lose focus on the payments that are made to unrelated third parties. They may also lack a solid foundation against which payments to related parties can be benchmarked.

APRA is well placed to survey fee arrangements for material outsourcing arrangements such as administration, custody and investment management. As the regulator, APRA can do this in a way that does not compromise confidentiality agreements to which RSEs may be committed.

Summary information can be provided to RSEs who can then compare the fees that they have negotiated with those in the market. This will also provide a basis for benchmarking relationships with related parties.

To illustrate, data for a specific type of investment mandate might be reflected in the following chart.

Figure 2: Illustration of a Fee Survey Data



An RSE faced with this data may identify that the fee being paid by them on a $4.2 billion mandate is high. This outlier might be justified – for example, it may relate to a mandate with a zero base fee and the total fee reflects a share of exceptional outperformance. However, it is also possible that the fee had not been renegotiated for some time and had become uncompetitive. The RSE would have to make a decision as to whether or not that particular manager warranted a premium fee.

Similar like-for-like comparisons could be completed for administration, custody, brokerage and other material activities.

By making fees more transparent as described in Point 1, there will be downward competitive pressure on the fees that RSEs charge for acting in their fiduciary roles. Providing information such as described in this Point 2 will provide competitive pressure on the fees being paid to unrelated third parties and provide a solid benchmark for RSEs to assess the arrangements with related third parties.

In combination, there will be downward pressure on all fees. RSEs will also have the incentive to identify and exploit investment opportunities in ways that disintermediate those established players who are charging too much. This will make the economy more efficient and improve retirement outcomes.

One extension that would tilt the competitive playing field heavily in favour of the Australian superannuation funds would be to only provide the data to the funds or, perhaps, provide information to RSEs only on those arrangements that are above the line-of-best-fit.

3. Material Functions

RSEs have a fiduciary responsibility to their clients. If the RSE also undertakes a material function such as investment management or administration, a situation will inevitably emerge that will compromise the objectivity of the RSE to assess its own performance in this material function. The RSE may apply standards that are either too high or too low relative to other providers in the market.

Although there are mechanisms by which RSEs may be able to overcome this lack of objectivity, a much clearer demarcation of responsibilities would be achieved if RSEs were required to outsource material functions. This outsourcing could be to related third parties that have their own governance structure or unrelated third parties. The RSE would then be able to assess the ongoing suitability of the arrangements through a more objective lens.

4. Product Suite

The Productivity Commission Issues Paper identifies a distinction between accumulation and decumulation. However there is an important third stage, which is the transition between the two.

Market volatility is largely irrelevant for those who are early in the accumulation phase. In fact, these people are advantaged when the market falls as their contribution buys more assets in a dollar-cost-averaging effect. As a result, risk-adjusted returns are of limited relevance in the early accumulation phase. The primary risk of concern in this stage is that money-weighted investment returns will not exceed inflation over the long term.

It is in the final 7 to 10 years of the accumulation phase that risk associated with market price movements becomes more important for most (but not all) participants as they get ready to draw down on their accounts. Sequencing risk becomes significant as the accumulation account is adjusted so that it is more suitable for the decumulation phase.

In the decumulation phase there is a distinction between those who will be drawing down over a relatively long period and those who have a shorter time horizon. For those with a longer term horizon the main risk relates to sustainability of income, assessed in combination with the operation of the aged-pension. Risk of capital devaluation is more significant for those with a shorter horizon.

Income in retirement is the ultimate purpose for superannuation. Within that, there are three distinct phases. RSEs should be encouraged to develop of distinctive products and approaches to meet the three distinct purposes of accumulation, transition and decumulation. Good independent advice can make a material contribution and could be considered to be a valid part of the product.

5. Advice

A common tool used in providing financial advice is designed to determine risk tolerance. It can be useful. However, it is flawed and can be dangerous if used in the wrong way.

Specifically, risk tolerance is subjective. It changes in response to market events. We should not be surprised if many investors sell after the market has fallen. Implicitly, they are instructed to do so as their risk tolerance decreases as a response to the market falls.

Good financial planners are adept at identifying the purpose for which different amounts of money are being invested and tailoring strategies to meet return and risk objectives that are relevant those purposes. Naïve use of risk profiling should be discouraged as it fails to take proper account of behavioural factors.

6. Reporting

Income in retirement, to replace or supplement the aged pension, is the purpose for superannuation. In contrast, reporting often centres on account balances that can fluctuate quite sharply without any significant impact on future income generation.

In fact, for those who are young and for whom the main asset is future contributions and future investment returns, falls in asset prices in the early years should not be of any major concern. They allow those contributors to buy assets that are "on sale".

Changing the focus for reporting from account balance to current income in the portfolio, along with projected income at retirement, will provide greater appreciation of the purpose for which the superannuation account will be used. It will also lead to less concern over short term fluctuations in valuations of assets.

7. Surveys

Performance surveys focus on time-weighted rates of return – a return that no participant in the superannuation system actually receives. Money-weighted returns and income in retirement are most relevant for those who are in the superannuation system. Those who provide surveys of fund returns should be encouraged to develop surveys that focus on money-weighted returns and income in retirement.

8. Engagement

There is a presumption in the Issues Paper that lack of engagement is bad and engagement is good. This is mostly true when dealing with certainties but many people do not have a good understanding of probability and the variability inherent in investment markets.

Many who engaged at the time of the GFC did themselves a lot of irreversible harm by selling after the market fell.

Recent research presented by Susan Thorp[1] identified that those who are in an SMSF are more likely to have higher engagement, higher knowledge of SMSF rules and are more likely to assess themselves as having a high understanding of finance. In contrast, her research showed that they are more likely to have lower numeracy and lower financial literacy than other participants.

As a result at least a subset of SMSF members, who are presumed to be engaged, are likely to do themselves harm.

For some in the superannuation system, relying on a properly motivated RSE may be more beneficial than trying to be more engaged. It makes sense to acknowledge this.

9. CGT Leakage

Superannuation earnings are taxed in the accumulation phase and untaxed in the decumulation phase. However, a number of superannuation funds do not segregate assets.

As a result, earnings through capital gains may remain untaxed in the superannuation system. This represents a tax leakage and could distort investment behaviour.

The potential overall leakage is extreme when leverage in the accumulation phase attracts a tax deduction on interest payments used to purchase assets on

[1] **SMSF members: Their attitudes, motivations and experiences**
http://www.cifr.edu.au/site/Latest_news/Research_Showcase_Superannuation.aspx

which capital gains tax is never paid.

This leakage could be closed by deeming capital gains to be realised at the time a superannuation account transitions from the accumulation phase to the decumulation phase. It is possible that the potential revenue from closing this leakage could be better directed to other parts of the economy.